IT 98-0091 GIL 11/18/1998 EXEMPT ORGANIZATIONS - S CORPORATIONS

General Information Letter: An Employee Stock Ownership Plan, which is exempt from federal income tax under 26 U.S.C. § 501(a) and that owns stock of a Subchapter S corporation, is taxed by Illinois only on its unrelated business taxable income.

November 18, 1998

Dear:

This is in response to your letter dated November 2, 1998 in which you request a letter ruling. The nature of your letter and the information you have provided require that we respond with a General Information Letter (GIL) which is designed to provide general information, is not a statement of Department policy and is not binding on the Department. *See* 2 Ill. Adm. Code 1200, enclosed.

In your letter you have stated as follows:

> xxxxx xxxxxxxxxxxx, xxx., xx-xxxxxxx, is an April 30 year end Michigan based construction company which performs a portion of its construction activity in your state. In 1997, the Illinois apportionment percentage was .22117%. Effective May 1, 1998, xxxxx xxxxxxxxxxxx, xxx. (x.x.x.) has been approved as an `S' corporation.
>
> The Taxpayer Relief Act of 1997, for the first time, created a scenario where ESOP's do not pay income tax on S distribution earnings. Attached to this letter are copies of the pertinent Federal IRC documents. x.x.x. is 100% ESOP owned.
>
> We asked for a ruling from our home state (Michigan) on the taxability of `S' corporation earnings to an ESOP shareholder. The State of Michigan ruled that under this scenario earnings would not be subject to Michigan income tax (see attached copy). It is our intention to follow Michigan's ruling in other states we operate in unless otherwise notified.
>
> In Illinois, it would appear that x.x.x. would still be liable for replacement tax on Form IL-1120-ST. It would also appear that the ESOP Trust would <u>not be liable</u> for replacement or income tax as the ESOP will have no Federal taxable income by definition.
>
> We specifically request you review our data and indicate your agreement or disagreement with our position.

RULING

Section 201(a) of the Illinois Income Tax Act ("the IITA"; 35 ILCS 5/101 *et seq.*) imposes a tax measured by net income on every individual, corporation, trust, and estate on the privilege of earning or receiving income in Illinois. In addition, section 201(c) of the IITA imposes the Personal Property Tax Replacement Income Tax ("RIT") measured by net income on every corporation (including Subchapter S corporation), partnership, and trust.

1. X.X.X.

Section 205(c) of the IITA exempts a Subchapter S corporation from the income tax imposed by section 201(a), but not the RIT imposed by section 201(c). Accordingly, a Subchapter S corporation is liable for RIT on the portion of its base income allocable to Illinois (See IITA §202, 203(e)(2)(G)). The base income of a Subchapter S corporation is defined at section 203(e)(2)(G) of the IITA as its federal taxable income determined in accordance with section 1363(a) of the Internal Revenue Code ("IRC"), but to include the items required by IRC section 1363(b)(1) to be separately stated. Section 308(c) of the IITA states that the base income of a Subchapter S corporation shall be allocated or apportioned to this State as it is allocated or apportioned for any other nonresident.

The RIT imposed by section 201(c) applies to a Subchapter S corporation regardless of the tax-exempt status of its shareholders. Accordingly, since X.X.X. earns income from business activity in Illinois, it will be subject to RIT to be reported on Form IL-1120-ST.

2. ESOP

Section 205(a) of the IITA states that the base income of an organization which is exempt from federal income tax by reason of section 501(a) of the IRC shall be its unrelated business taxable income under IRC section 512. Section 501(a) of the IRC exempts from federal income tax an organization described in IRC section 401(a). An ESOP qualifies as an organization described in section 401(a) (See IRC §4975(E)(7)), so that its Illinois base income is its unrelated business taxable income. Accordingly, to the extent that the pro rata share of items of an ESOP shareholder of a Subchapter S corporation do not constitute unrelated business taxable income under IRC section 512, the same will not be subject to Illinois income tax under either IITA section 201(a) or 201(c).

As stated above, this is a GIL which does not constitute a statement of policy that applies, interprets or prescribes the tax laws, and it is not binding on the Department. If you are not under audit and you wish to obtain a binding Private Letter Ruling regarding your factual situation, please submit all of the information set out in items 1 through 8 of the enclosed copy of section 1200.110(b).

Sincerely,

Brian L. Stocker
Staff Attorney (Income Tax)